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No. 80-199

In the Supreme Court of the United States

OCTOBER TERM, 1979

BERKLEY MACHINE WORKS & FOUNDRY COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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The question presented in this federal income tax case is whether petitioner satisfied the strict substantiation requirements established by Section 274 of the Internal Revenue Code of 1954 (26 U.S.C.) so as to permit the deduction of expenses it incurred in the operation of a hunting and fishing lodge located on Ocracoke Island, North Carolina.

The pertinent facts may be summarized as follows: Petitioner operates a foundry, pattern shop and machine shop for the manufacturing of metal castings and forgings. It owns a hunting and fishing lodge on Ocracoke Island, located on North Carolina's Outer Banks (Pet. App. 3a-5a, 33a). During 1963-1967, petitioner invited certain of its customers' employees to visit the Ocracoke facility for

hunting and/or fishing weekends. Petitioner's customers would decide which of their employees would be allowed to go, and it was not unusual for these employees to be accompanied on the trips by their wives and children (Pet. App. 6a, 33a-34a).

On audit, the Commissioner concluded that petitioner had not maintained the records required by Section 274 of the Code showing the names of the guests entertained at Ocracoke or the business purpose of each of these fishing weekends. Accordingly, the Commissioner disallowed the business deductions petitioner had claimed with respect to its Ocracoke facility. Petitioner thereafter filed suit in the Tax Court seeking redetermination of the deficiency. In that court, petitioner attempted to supply the missing factual data by offering the testimony of nine witnesses who had been guests at Ocracoke at various times during the years in question. These witnesses testified generally that business matters had come up during these fishing weekends, although not according to any prearranged plan. As one of the witnesses testified, "you wind up talking shop when other things are not happening" or when "fishing was poor" (R. 189-190).[1]

After noting that the trial testimony "provided in detail some of the specific jobs or projects discussed during certain visits to the island" (Pet. App. 27a), the Tax Court held that the Ocracoke visits were directly related to the active conduct of petitioner's business and that the business purpose of the visits and the business relationship of the guests entertained were adequately substantiated within the meaning of Section 274 of the Internal Revenue Code and the Regulations thereunder (Pet. App. 15a-31a).

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[1] "R." refers to the separately bound record appendix filed in the court of appeals.

The court of appeals reversed (Pet. App. 32a-50a). It held that petitioner's Ocracoke expenses "were in the area of general business goodwill," and that, accordingly, the expenses were not "*directly* related to the *active* conduct of its business as contemplated by [Code Section 274's] statutory language and history and by the Regulations" (emphasis in original) (Pet. App. 41a-42a). In addition, the court concluded that petitioner had failed to substantiate the business purpose of each of the 76 trips taken to Ocracoke and the business relationship of the more than 1,000 guests entertained there, as required by Section 274(d) of the Code (Pet. App. 47a).

1. The court of appeals correctly held that petitioner failed to satisfy the substantiation requirements under Section 274 of the Code so as to justify deduction of its hunting and fishing lodge expenses. In 1962, Congress enacted Section 274 to deal with the "widespread abuses" associated with the deductions claimed for "business" entertainment expenses. As the Senate Finance Committee Report noted (S. Rep. No. 1881, 87th Cong., 2d Sess. 25 (1962)), the provision was designed to restrict "deductions for entertainment and traveling expenses * * * to prevent abuses." An important component in this legislation was the adoption of rules designed to eliminate the deduction of entertainment expenses designed mainly to generate "good will"[2] (Pet. App. 28a, 42a). See

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[2]Contrary to petitioner's argument (Pet. 6), in enacting Section 274, Congress specifically intended to bar deduction of entertainment expenses that might have qualified for deduction under the more general requirements of Section 162. As the House Committee Report (H.R. Rep. No. 1447, 87th Cong., 2d Sess. 20 (1962)) indicated:

> With respect to expenses for entertainment activities, the bill provides that a deduction will be allowed only to the extent that the taxpayer establishes that the expense was directly related to the active conduct of his trade or business. This means that the taxpayer must show a greater degree of proximate relation

Hippodrome Oldsmobile, Inc. v. *United States*, 474 F. 2d 959 (6th Cir. 1973). Specifically, Section 274 provides that no deduction shall be allowed for any expenditure relating to the operating costs of an entertainment facility unless the taxpayer not only establishes that the expenditure is directly related to the active conduct of his trade or business, but also substantiates (A) the amount of the expense, (B) the time and place it was incurred, (C) its business purpose, and (D) the business relationship of the persons entertained.[3]

The detailed legislative Regulations promulgated under Section 274 have implemented the congressional purposes. They provide that an expenditure for entertainment, even if business-related within the meaning of Section 162, is not deductible unless "the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure." Treasury Regulations, Section 1.274-2(c)(3)(i).

The court of appeals properly held that the deductions claimed here with respect to "fishing weekends" were barred by Section 274. None of the trips to Ocracoke

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between the expenditure and his trade or business than is required under present law. Among other things he will have to show more than a general expectation of deriving some income at some indefinite future time from the making of the entertainment-type expenditure * * * .

See S. Rep. No. 1881, *supra*, at 25.

[3]The question presented in this case has no continuing importance. Under the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, enacted November 6, 1978, expenses incurred after December 31, 1978, with regard to hunting and fishing lodges are no longer deductible regardless of the extent of the business connection. See Section 361 of the Revenue Act of 1978; H.R. Conf. Rep. No. 95-1800, 95th Cong., 2d Sess. 248-251 (1978).

carried a prearranged business agenda, and the business discussions that occurred there were "informal and general in nature, of the sort that inevitably arise when people whose common bond is business are together" (Pet. App. 42a). Indeed, petitioner's own witnesses could recall only 12 informal business discussions that occurred at all during the five-year period at issue in which 76 separate trips to Ocracoke Island were made (Pet. App. 47a). In these circumstances, the court of appeals correctly held that petitioner's goodwill-oriented expenses relating to the operation of its Ocracoke facility were not directly related to the active conduct of its trade or business. As it stated (Pet. App. 42a; emphasis in original):

> We think that Berkley's evidence, consisting of undocumented recollections by witnesses whose memories were clouded by the passage of time so that most could not positively recall even the *year* when these discussions took place, cannot be considered to establish clearly that the active conduct of business took place on all these occasions. At most it reveals that the benefits derived by Berkley from these weekends were in the area of general business goodwill, exactly the type of expenditure that Congress intended to eliminate as a deduction by means of the directly related test.

See *Handelman* v. *Commissioner*, 509 F. 2d 1067, 1074 (2d Cir. 1975); *St. Petersburg Bank & Trust Co.* v. *United States*, 362 F. Supp. 674 (M.D. Fla. 1973), aff'd, 503 F. 2d 1402 (5th Cir. 1974).

2. Nor was there any substantiation of the business purpose of each of the trips to Ocracoke or the business relationship to petitioner of each of the guests entertained there, as required by Section 274(d). As the Fifth Circuit

has held, petitioner was required to establish, for each of the 76 trips, the "specific business discussed." *Dowell* v. *United States*, 522 F. 2d 708, 709 (5th Cir. 1975), cert. denied, 426 U.S. 920 (1976). Here, however, petitioner failed to establish either the business purpose of each of the trips or the business relationship of the over 1,000 guests entertained at Ocracoke Island during the taxable periods at issue. Indeed, the evidence presented at trial clearly showed that not all of the guests invited to Ocracoke by petitioner's corporate customers had a bona fide business relationship with petitioner. Thus, petitioner failed to furnish even circumstantial proof that substantial business discussions took place on every trip to Ocracoke.[4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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[4]Thus, contrary to petitioner's contention (Pet. 9), the decision below does not conflict with *Dowell* v. *United States*, *supra*. There, the taxpayer presented evidence establishing the business purpose of various luncheons and dinners. As in the present case, however, he failed to substantiate "each and every element (amount, date, place, business purpose, and business relationship) of each and every expenditure" (522 F. 2d at 714). Just as in the decision below, the court in *Dowell* disallowed the claimed entertainment expense deductions.

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